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SUBJECT: Part I: Latest Economic Data Sends HCMC Analysts Into A Panic

Refs: A) Hanoi 610, B) Hanoi 606, C) HCMC 359, D) Hanoi 572

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¶1. (SBU) Summary: After a record of good performance through the first half of 2007, missteps in fiscal and monetary policy have set the stage in 2008 for concerns that the GVN needs stronger macro-economic management. High inflation, exchange rate fluctuations and lack of SOE control have eroded confidence in the GVN's ability to manage its economic growth in a sustainable manner. Many analysts are becoming increasingly shrill in their warnings. There is cause for concern, but right now the situation is one of speculation, mostly focused on the ability of the GVN to manage its way out of the situation. Clearly, some analysts are looking to make headlines, but the multilateral developments banks have some confidence that the GVN has the ability to deal with the current period of instability. The next three to six months will be a test of the GVN's ability to make the correct monetary and fiscal decisions. End summary.

Optimists, Pessimists, and Those In Between

¶2. (SBU) Experts in HCMC looking at Vietnam's economy tend to be easily divided into two camps: the optimists and the pessimists. To a great extent, the optimist camp is composed of long-term investors such as factory owners who see considerable additional growth potential in Vietnam while the pessimist camp is composed of investors with a shorter term perspective, such as stock market, financial and real estate investors capitalizing on the real estate boom that has been sweeping Vietnam for the past few years. Even among the pessimists, most turn immediately optimistic when the discussion turns to Vietnam's long-term prospects. The multilateral development banks take a less polarized approach. The IMF Resident Representative acknowledges that headline economic numbers are not good and probably won't be for some time, but calls the current situation more of a "confidence game" about the GVN's ability to manage its fiscal and monetary policy. He adds that lack of timely and reliable economic data only fans the flames of speculation, as analysts and investors tend to fill in the blanks with worst-case scenario information. In his estimation, the new budget and higher interest rates will have some effect, but it is too early to say what that effect will be.

FDI Must Stay Strong

¶3. (SBU) Many analysts (e.g., HSBC, Standard and Poor's, UBS, Standard Chartered, etc., as well as domestic Vietnamese analysts at private investment funds) have begun to focus on how Vietnam's

current account deficit and GVN inflation policy could hurt investor confidence as well as on how a fall in investor confidence would then diminish Vietnam's ability to service its current account deficit. If foreign direct investors (FDI) and/or portfolio investors -- foreign indirect investment (FII) -- do not continue to pour money into Vietnam at a rate at least equal to that of 2007, the country will not be able to finance its growing trade deficit. Fortunately, as of April 22, total registered FDI for the year was at 7.6 billion USD, up by 41.4 percent over the same period in 2007, meaning that FDI flows are continuing and are on pace to increase over last year. Some businessmen do expect the global slowdown will have some effect on inflows later in the year.

Inflation Gets the Ball Rolling

¶4. (SBU) While the May 2008 year-on-year inflation of more than twenty-five percent is quite high, even that figure understates the price increases currently being felt by Vietnamese consumers since the present inflationary spike began only five or six months ago (reftels). By May, prices were already nearly 16 percent above their level in January 2008, which is equal to an annualized inflation rate of nearly 40 percent. Financial analysts point to the GVN's failure to properly sterilize surging capital inflows in 2007 as causing the money supply to rise by 46 percent in 2007 and credit to expand by 54 percent. Predictably, this money supply growth sparked inflation in 2008. Unsterilized capital inflows were not the only culprit behind the expanding money supply. As part of the GVN's fixation on maintaining a stable dollar-dong exchange rate, the SBV consistently purchased dollars for dong in 2007 to keep the exchange rate from appreciating against the USD (reftel), pumping more dong into the economy. These monetary policy errors were compounded by lack of budgetary discipline: massive amounts of state investment into highly inefficient State Owned Enterprises (SOEs) were channeled rapidly into "bubble" areas of the economy, such as real estate speculation and stock market investments. One

senior foreign banker recently told us that many of the affiliated banks opened by Vietnamese SOEs in 2007 were little more than cash machines to transform modest capital investments into huge lending portfolios directed almost exclusively to the SOEs' directors, their families and political backers. Recent statements by the PM that the GVN plans to get control of SOE spending are a step in the right direction, but economists are watching to see if these statements are backed up by decisive action.

Compounding Policies

¶5. (SBU) As the inevitable inflationary surge resulting from the exploding money supply became evident in early 2008, analysts argue, the GVN and State Bank of Vietnam (SBV) attempted to react using well intentioned but ineffective administrative measures. Rather than tightening monetary policy via interest rates, the SBV maintained a cheap money policy with deposit and lending rates capped well below the rate of inflation (at 12 percent and 14 percent, respectively). The resulting negative real interest rates for depositors and borrowers alike squeezed liquidly out of the banking system at the same time it increased the demand for credit. The SBV reduced liquidity in the banking system further by requiring most financial institutions to purchase government bonds paying just 7.8 percent interest. The recent removal of interest rate controls has helped reduce tensions, although rates are still effectively capped at 18 percent for both depositors and borrowers, meaning that real (inflation-adjusted) interest rates remain below zero (reftels). The SBV also moved recently to raise the base and discount rates, and while the IMF thinks they are still too low, the SBV has indicated a willingness to reevaluate the current rates depending on how the situation develops (reftel).

¶6. (SBU) By spring of 2008, the Vietnam's booming private sector was feeling the effects of this combination of policies, with many manufacturers and exporters unable to obtain the operating credit they needed. Much of the lending that did occur was directed lending by state-owned commercial banks (SOCBs) to inefficient SOEs. Those banks -- primarily SOCBs or banks owned by the largest SOEs -- whose large branch networks and/or large employment base enable

them to maintain a large (captured) deposit base despite low deposit interest rates continue to make a profit, particularly because a number of banks have been able to lend at 20 - 22 percent despite formal controls to the contrary. Smaller or less well-connected banks, however, are losing deposits and may face bankruptcy. Analysts are watching to see if the PM's statements on SOE control will apply to these banks, as well.

The Financial Crisis Theory

¶7. (SBU) Proponents of the financial crisis theory in HCMC point to a number of factors and policies that are leading Vietnam toward financial instability. Very high inflation combined with a relatively inflexible exchange rate policy means that in real terms the dong is rapidly appreciating versus the dollar. Negative real interest rates on dong-denominated deposits (even after the recent liberalization) place additional downward pressure on the dong. While some press has speculated that the GVN will announce a much needed widening of the trading band on the dong (from 1 to 2 percent), market pressure is mounting for a steeper depreciation. Published reports indicate that open market and black market rates on the dollar had climbed to 17,750 dong by May 28, which represents a depreciation of nearly ten percent from the official rate and is well below the critical psychological level of 17,000 that many cite as the rate beyond which the GVN does not want the dong to fall. The exchange rate market will continue to be the real barometer of the level of speculation and where the "herd mentality" is headed. In recognition of this, the SBV made a public announcement earlier this week that it had sufficient liquidity to defend the dong, which seems to have calmed the market considerably.

¶8. (SBU) Downward pressure on the dong is being increased by the interest rates available on dollar-denominated accounts held in Vietnamese banks. In contrast with the negative real rate on dong deposits, the current six percent rate paid on dollar deposits is well above the U.S. inflation rate and above the rates available to most U.S. depositors, thus encouraging investors to sell dong in order to buy dollars. Another clear indicator that GVN policies are serving to drive money out of the banking system and onto the street is the skyrocketing demand for gold. The World Gold Council reported that Vietnam was the world's largest buyer of gold in the first quarter 2008, up 140 percent over the same quarter in 2007 to 32 tons.

¶9. (SBU) The Central Bank has reportedly already spent in excess of $2 billion defending the dong. The "doomsday" thinking goes that with losses like those over the past few months, the GVN's current policy of using open market purchases to support for the dong may soon prove impossible -- or too expensive -- to maintain. If the GVN then decides to implement non-market mechanisms such as currency controls to prevent the dong from falling further, the unintended consequence would be to adversely impact capital inflows. Anxious "hot money" investors in the stock and financial markets could well head to the doors if they fear that the GVN would block them from repatriating capital, and even if existing investors do not (or cannot) leave, once currency controls were in place Vietnam would be unlikely to attract the types of additional inflows required to finance a current account deficit. Our contacts at the SBV, however, indicate that Vietnam has sufficient reserves to defend the dong for the better part of a year while the necessary policy adjustments are made.

¶10. (SBU) Proponents of the crisis theory in HCMC also cite other factors as contributing to what they see as an upcoming "perfect storm" of financial variables and mis-directed policies. Vietnam's current account deficit continues to mushroom, surpassing the target for all of 2008 in just the first five months of the year. One analyst predicts the deficit may reach 19 percent by the end of 2008, nearly double the 10 percent of GDP level that many believe precipitated the financial crisis in Bangkok in 1997. Until recently, however, Vietnam's current account deficit was made up largely of capital investment goods (machinery, etc.) and was financed by inflows of equally long-term FDI. Beginning in 2007, the crisis theorists state, the situation began to change as the

value of imports soared well above the value of export earnings and FDI combined. This left Vietnam financing imports with Foreign Indirect Investment, which includes quite a bit of short-term "hot money" that can flow out as quickly as it flowed in. Analysts argue that a slow-down in the rate at which additional FII flows could push Vietnam towards financial instability, but this argument is weakened by the fact that most of the estimated $10 billion held by investment funds in Vietnam resides in long-term, closed-end funds. Furthermore, regular data on "hot money" flows is lacking, making analysis of this type difficult to verify.

¶11. (SBU) Despite central government policy that remains firmly in favor of attracting more FDI, many provincial officials across the south are evidently drawing a simplistic direct line between FDI inflows and inflation. By focusing on the FDI flows themselves rather than Vietnam's inappropriate fiscal policy as the root cause of inflation, some officials appear to have decided that they should contribute to the fight against inflation by slowing the inflow of FDI. At their monthly breakfast at the CGR, AmCham's leaders uniformly expressed their belief that provincial authorities may be slowing the processing of permits and are erecting other red tape barriers in a well-intentioned but clumsy attempt to slow FDI. A recent lunch of Consuls General in HCMC revealed that other major investors share this perception. If central authorities are unable to reverse these provincial policies, the composition of Vietnam's balance of payments could further deteriorate.

Getting Vietnam's Economy Back on Track

¶12. (SBU) Most in HCMC's financial sector argue that abandoning distorting administrative measures and liberalizing exchange rate and interest rate mechanisms remain Vietnam's best bet to tackle inflation and restore financial equilibrium. The more holistic thinkers add that meaningful administrative reform projects will help turn pledged FDI in implemented FDI, helping to keep the all-important capital inflows coming to finance the investment goods imports needed for Vietnam's continued growth. Better judgment in government spending, SOE investment and state-owned commercial bank lending, firmly based on sound economic decision-making, would boost investor confidence, increase the efficiency of investment and build Vietnam's capacity to grow.

¶13. (SBU) Long-time Vietnam watchers in HCMC, though equally pained by short-term loses, remain more sanguine and call for a steady continuation of systemic reforms: cutting red tape, reducing the still bloated SOE sector, strengthening the judicial system and internalizing the trade investment rules that Vietnam agreed to on joining the WTO. They point to the steep drop in Vietnam FDI in 1998 just after the Asian Financial Crisis -- including a credit crunch and the bottom dropping out of the property market -- as an

indication that Vietnam has not escaped past economic cycles. "Making the tough economic choices requires a level of pain," a leading fund manager said earlier this year, "and the Vietnamese pain threshold is remarkably high."

Comment

¶14. (SBU) A serious financial situation in Vietnam is not inevitable, but it is possible, including bankruptcy for some of the smaller, newer banks. Just how likely it is depends to a great extent on what the GVN does next. Vietnam must recognize the serious macroeconomic challenges facing its economy and gather the political will to act. A number of our contacts -- particularly Vietnamese analysts -- lament that many in the GVN are simply more comfortable trusting direct controls than market mechanisms. Unfortunately, while administrative controls are seductively simple, they rarely work as intended and more often backfire in practice. At this stage, what Vietnam needs most is good advice and the will to follow it. Luckily, advice is not in short supply from monetary authorities such as the IMF and regional development banks, from its ASEAN neighbors and from donor countries. Department of Treasury technical assistance -- strengthening bank supervision, tax reform and debt management -- will prove valuable. Indeed, these bodies

have been giving the same good advice for months already. In the long term the United States can best help Vietnam to avoid future financial crises by increasing Vietnam's long-term capacity for economic governance, especially through the USAID-funded Support for Trade Acceleration (STAR) program which helps build the GVN's capacity for everything from cutting red tape via Project 30 to mobilizing capital for infrastructure through municipal and provincial bond issuances. Post will continue to follow the situation closely and will report septel. End comment.

¶15. (U) This cable was drafted by Con Gen HCMC in coordination with Embassy Hanoi and the Regional Financial Attache at Embassy Singapore.

MICHALAK